Portuguese storm gathers as EU leaders fight over Greece

Surging borrowing costs in Portugal have raised the spectre of a second full-fledged contagion crisis in the eurozone, eclipsing the latest efforts by European Union leaders in Brussels to agree on Europe's bail-out machinery and a strategy for Greece.

Angela Merkel, Germany's chancellor, back center, speaks with Pedro Passos Coelho, Portugal's prime minister, back left, in Brussels on Monday. Photo: BLOOMBERG

By Ambrose Evans-Pritchard, International Business Editor 9:19PM GMT 30 Jan 2012

Yields on Portuguese 10-year bonds hit a fresh record of 17.38pc on Monday even though the country is already shielded by a €78bn (£65.2bn) package from the EU, European Central Bank and International Monetary Fund "troika" and does not have to tap the markets this year.

Equity markets fell across Europe, with France's CAC and Spain's IBEX both down 1.6pc.

The FTSE 100 fell 1.1pc and Germany's DAX was off 1pc, while the iTraxx Crossover index measuring credit risk in Europe jumped 30 points to 637. Yields on Italian 10-year debt rose 21 points to 6.08pc.

The worries over Portugal continued to mount even as German Chancellor Angela Merkel backed away from demands for a European austerity commissioner to take control of the Greek budget, averting an explosive clash with Athens.

"We don't want controversial talks, but a discussion that is successful for the Greek people," she said, insisting that Germany's plan was just one many of options.

The change of tack came after Berlin's allies in the northern creditor bloc warned such heavy-handed diplomacy had become offensive and breached the spirit of the EU project.

"You never stoop to insults in politics. It solves nothing," said Austria's Chancellor Werner Faymann. Luxembourg's foreign minister Jean Asselborn said it behoves Europe's most powerful state to display a "little more caution", advising Germany to "watch out" as passions grow stronger.

The dispute overshadowed the summit, intended to promote EU growth and tackle youth unemployment – now 22pc Europe-wide and 51pc in Greece. Talk of growth at a time when EU austerity has entrenched severe slumps across southern Europe has left markets bewildered.

While EU leaders fleshed out a German-inspired "fiscal compact" to police the budgets of EMU states, Finland called it "at best unnecessary and at worst harmful" while Luxembourg deemed it a "waste of time". The pact has been weakened, allowing a breach of the new structural deficit limit of 0.5pc of GDP in a wider range of circumstances.

On Monday night, 25 of the 27 EU nations signed up to the fiscal compact, with the Czech prime minister joining the UK in staying outside the deal.

While German calls for an EU commissar for Greece are not new, the aggressive tone of the draft shocked EU veterans. It stipulated that Athens must give "absolute priority to debt service", "transfer national budgetary sovereignty", and agree to terms that make it impossible for Greece to "threaten lenders with default". Furious Greek leaders rejected the terms as debt servitude.

Analysts have questioned whether Germany deliberately called for conditions that Athens cannot accept, perhaps to force Greece's withdrawal from the euro and set an example to others.

The softening of the German stance does not in itself settle the Greek crisis – even assuming Athens agrees soon to a deal with private creditors for debt relief near 70pc. Greece will almost certainly need a further €15bn on top of the €130bn package in force, yet Mrs Merkel has warned that Germany will not provide any further funds.

Jacques Cailloux from RBS said there would be a chain reaction if the troika halts payments and sets in motion a Greek default and exit from EMU.

"That would the disaster scenario. Those who think this could be contained don't know what they are talking about. There would be extraordinary contagion, as we are already seeing in Portugal, spreading back to Spain, Italy, and France," he said.

Citigroup thinks Portugal's economy will contract by 5.7pc this year and 3.5pc next year, replicating the downward spiral seen in Greece as austerity began to bite.

While Portugal has delivered on its promises, the task may be Sisyphean with a combined public and private debt of 360pc of GDP – 100 percentage points higher than in Greece. Grit alone cannot overcome the same chronic lack of competitiveness.

Europe's leaders have vowed that they will not inflict a "haircut" on Portugal's creditors, insisting that Greece is a "special case". The relentless exodus from Portuguese debt suggests that investors do not believe them.

http://www.telegraph.co.uk/finance/financialcrisis/9050601/Portuguese-storm-gathers-as-EU-leaders-fight-over-Greece.html